Thinking Things Over / *By Robert L. Bartley*

Economic Profit vs. Accounting Profit

To William J. McDonough:

Dear Bill, I'm sure you're busy enough getting ready to take over the Public Company Accounting Oversight Board next week, but there's one unlikely task you ought to work in. Reread Frank Knight's "Risk, Uncertainty and Profit."

I also see that the PCAOB is set to appoint an advisory board to rewrite accounting standards, so here are a couple of nominees: Peter J. Wallison and G. Bennett Stewart III, whose thinking you can sample on the adjoining page. You need them precisely because their views will appall the accountants surrounding you. For while there has been some cheating and corner-cutting, the real problem with corporate reporting is conceptual.

DEBATING SARBANES-OXLEY

EPS, the familiar earnings per share, is supposed to measure corporate profit, as determined by GAAP, or generally accepted accounting principles. But economists have long recognized that profit is something of a mystery, and that economic profit is by no means the same thing as accounting profit. Professor Knight, a progenitor of today's Chicago school of economics, published his classic book back in 1921, based on his doctoral dissertation written in 1911.

The crude Marxist labor theory of value held that profit is any income to a proprietor—the better to justify notions of class struggle. But as far back as Adam Smith, more careful economists have recognized this as fallacious. A proprietor typically provides an enterprise with management, for example, a necessary task as deserving of a wage as the sweat of the workman on the floor. So part of his return is not profit but compensation for his labor.

The historical proprietor also contributed capital, essential to producing products and jobs. The old economists dealt with land that could be put out to rent; since the rent would not depend on the success of the enterprise, the return to land was not profit. Today it's possible to rent capital, either by borrowing or by issuing equity. Lenders charge interest, while providers of equity capital have an opportunity cost of what they could earn elsewhere. Like rents on land, this cost is fixed whether the enterprise succeeds or fails. That is to say, some of the return to equity—part of EPS—should be seen as a payment of interest, not as profit.

Various other charges such as insurance have historically been charged to the proprietor's share. Profit is what is left from gross income after all the hired factors of production have been paid. As Knight puts it, "the residuum of product remaining after payment is made at rates established in competition with all comers for all services of men or things for which competition exists." More succinctly, "profit is unimputable income."

This is something quite different from EPS under GAAP. And "Risk, Uncertainty and Profit," has an instructive section on the distinction between economic profit and accounting profit. In particular, the issue of interest on equity "has tended to constitute an issue between accountants and economic theorists." This is "entirely uncalled-for" he concluded, because "the difference in opinion is a matter of obvious difference in standpoint." The economist is interested in the dynamic forces of production, while "The accountant is interested in proprietorship, the relations between a business and its owners, and in cost as a deduction from the owner's income."

He warned that the economic conception of profit "cannot be carried to theoretical completeness" because it is difficult to quantify. But he adds, "it is useful, however, to distinguish between the return actually realized by the entrepreneur and the 'competitive' rate of interest on high-class 'gilt-edge' securities where the risk and responsibility factor is negligible. The difference would be profit, or 'pure profit,' in the sense in which economic theory uses the term."

Terry Shoffner

Frank Knight

From the standpoint of public policy on modern capital markets, this lets the accountants off rather easily. The purpose of capital markets is to direct scarce capital to its highest uses. The highest uses depend on economic profit—rates of return on assets—not on accounting profits. Yet the Sarbanes-Oxley Act that established the Accounting Oversight Board also enshrined EPS and GAAP more firmly than ever. The act puts impediments to revealing economic-profit numbers such as Mr. Wallison's cash flow or Mr. Stewart's EVA.

Yet these are precisely the kind of numbers sophisticated CEOs and CFOs use for internal management. At its best, indeed, securities analysis is about converting reported accounting profits into meaningful economic profits, but analysts who can do that are hired away to run hedge funds and the like. They leave behind the earnings-per-share crowd to hector managers about accounting profits, persuading them that this is what drives share prices.

I'm alert to this issue because I remember that back in the 1970s I persuaded Peter Drucker to write a regular column for the Journal, and his first two entries were about the meaning of profit (see posting on OpinionJournal.com). He was scathing about EPS: "What it really represents is 'taxable earnings.' It is what is left after all the charges the tax collector accepts as deductible. But this is a purely arbitrary figure that has little or nothing to do with business performance." And, "the essential fact about profit is that there is no such thing. There are only costs."

He also had some things to say about your current mandate at the PCAOB, to wit: "The key figure for this is return on all assets (or on capital employed), related to cash needs, to cost of capital, to risks and needs. This rather than the meaningless 'earnings per share' figure is what the public, the SEC, analysts and, above all, the stockholders should expect—and might demand—from a company's published accounts and annual statements."